04-0970
AUDIT
SIGNED 12-11-08

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 04-0970 Account No. ##### Tax Type: Corporate Franchise Tax Years: 06/01/96 – 05/31/97; 06/01/99 – 05/31/00 Judge: Chapman

Presiding:
Pam Hendrickson, Commission Chair
R. Bruce Johnson, Commissioner
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP 1, Attorney
PETITIONER REP 2
PETITIONER REP 3
For Respondent: RESPONDENT REP, Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on April 22, 2008. Based upon the evidence and testimony presented, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax at issue is Utah corporate franchise and income tax.

2. The two tax years at issue are June 1, 1996 through May 31, 1997 ("1997 tax year") and June 1, 1999 through May 31, 2000 ("2000 tax year").

3. On June 10, 2004, Auditing Division ("Division") issued a Statutory Notice to PETITIONER ("PETITIONER" or "taxpayer"), in which it imposed additional corporate franchise tax and interest for the 1997 and 2000 tax years, as follows (Exhibit R-1):

Year	Tax	Penalties	Interest	Total
1997	$$$$$	$$$$$	$$$$$	$$$$$
2000	$$$$$	$$$$$	$$$$$	$$$$$
				$$$$$

4. The $$$$$ in additional tax for 2000 results from the Division's determination that certain items of PETITIONER's capital gains and royalty income were business income subject to Utah taxation. The parties agreed that the $$$$$ in additional tax for 1997 concerns a net operating loss that is dependent on the Commission's decision concerning the 2000 assessment. Accordingly, the Commission need only address those issues concerning the 2000 tax year.

5. The assessment of additional tax for 2000 concerns the items of income listed below (Exhibits P-1 and R-1). The "Net Income Before Adjustments" tax amount is not at issue. PETITIONER has also chosen not to contest the taxes associated with the sales of assets for SUBSIDIARY 3, SUBSIDIARY 6, and SUBSIDIARY 8. PETITIONER is, however, contesting the tax assessed on the remaining items of income (in bold):

2000 Tax Year		**Income**	**Tax Assessment**
Net Income Before Adjustments:		($$$$$)	($$$$$)
Stock Sales:	**SUBSIDIARY 1**	**$$$$$**	**$$$$$**
	SUBSIDIARY 1	**$$$$$**	**$$$$$**
	SUBSIDIARY 2	**$$$$$**	**$$$$$**
Sales of Assets:	SUBSIDIARY 3	$$$$$	$$$$$
	SUBSIDIARY 4	**$$$$$**	**$$$$$**
	SUBSIDIARY 5	**$$$$$**	**$$$$$**
	SUBSIDIARY 6	$$$$$	$$$$$
	SUBSIDIARY 7	**$$$$$**	**$$$$$**

	SUBSIDIARY 8	$$$$$	$$$$$
Royalty Income:	**SUBSIDIARY 9**	**$$$$$**	**$$$$$**
	SUBSIDIARY 10	**$$$$$**	**$$$$$**

	$$$$$
Minus: Taxes Paid and Other Refundable Credits	($$$)
Total Additional Tax Due	$$$$$

6. PETITIONER argues that the contested items of income are either not subject to Utah taxation or, if taxable, should be subject to alternative apportionment, as follows:

a. First, PETITIONER contends that SUBSIDIARY 2, SUBSIDIARY 4 and SUBSIDIARY 5 are not part of its "unitary business." As a result, PETITIONER argues that Utah is constitutionally barred from imposing tax on the gains it received from these entities.

b. Second, PETITIONER contends that the gains associated with SUBSIDIARY 1, SUBSIDIARY 2, SUBSIDIARY 4, SUBSIDIARY 5, and SUBSIDIARY 7 are not "business income," as defined in Utah Code Ann. §59-7-302(1). PETITIONER argues that the gains are "nonbusiness income" that is not subject to Utah taxation.

c. Third, PETITIONER admits that the royalty income at issue, which it received from foreign subsidiaries, is business income that is subject to Utah taxation. However, PETITIONER asks the Commission to apply an alternative apportionment methodology that will reduce the amount of Utah tax due on this income.

d. Finally, if the Commission finds that the income derived from SUBSIDIARY 1 is taxable business income, PETITIONER asks the Commission to apply an alternative apportionment methodology to reduce the amount of Utah tax due on this income.

7. The Division asks the Commission to reject all of PETITIONER's arguments and to sustain the entirety of its assessment for the 2000 tax year. The Division asks the Commission to reach this

conclusion, in part, because PETITIONER claimed all of the income at issue as business income on its 2000 STATE 2 corporate franchise tax returns. The Division also asks the Commission to consider that other states, specifically Idaho and STATE 1, have determined that the income at issue is business income.

8. PETITIONER explains that STATE 2 has taken the position that all of the entities at issue were part of PETITIONER's unitary business for 2000. PETITIONER contends, however, that this fact should not influence the Commission's decision in the present case. In addition, PETITIONER asserts that the Idaho and STATE 1 decisions were issued after "informal" proceedings and that the matters are still under review in those states.

9. PETITIONER also called PETITIONER REP 3 as a witness to testify that corporate franchise tax uniformity between states should not be a determinative factor in this case. The Commission determined that PETITIONER REP 3 was an expert witness in matters concerning Utah's corporate franchise tax history, policy and procedures. PETITIONER REP 3 testified that uniformity among states concerning the administration of state corporate income tax has not been achieved for various reasons, which he described in his affidavit (Exhibit P-7). He also explained that varying court rulings and state policies preclude uniformity. For these reasons, PETITIONER REP 3 testified that the Commission's decision in this matter should not be based on how PETITIONER filed returns in other jurisdictions and how other jurisdictions have ruled on the issues now before the Commission.

PETITIONER

10. PETITIONER is a software company headquartered in STATE 2.

11. Both parties called PETITIONER REP 2, a CPA employed by PETITIONER, as a witness.

12. PETITIONER REP 2 testified that PETITIONER is engaged in four lines of business: 1) the sale of software; 2) consulting services for the implementation of its software; 3) support services for its

software; and 4) training and certification services associated with its products. PETITIONER REP 2 testified that PETITIONER engages in all of these lines of business in Utah, with the exception that it does not provide support services for its software in Utah.

13. PETITIONER's Utah corporate franchise tax liability increased significantly for the 2000 tax year when compared to its liability for years both prior to and after 2000 (Exhibit P-2). PETITIONER REP 2 testified that the 2000 tax increase was not due to PETITIONER's activities in Utah changing appreciably in 2000. Instead, PETITIONER REP 2 stated that the increased liability resulted from "aberrant" 2000 income that PETITIONER received because of its decision to take advantage of the robust stock market that existed at that time.

14. PETITIONER filed its 2000 STATE 2 corporate franchise tax return on a worldwide combined basis (Exhibit R-3). However, it filed its 2000 Utah return on a water's-edge combined basis (Exhibit R-2). PETITIONER did not report any of the income at issue in this appeal as nonbusiness income on its 2000 STATE 2 returns (Exhibit R-3; Exhibit R-4).

15. On PETITIONER's Form 10-K that it reported to the U.S. Securities and Exchange Commission for the fiscal year 2001 ("2001 Form 10-K"), PETITIONER indicated that "[a]s part of its business strategy, [PETITIONER] has made and expects to continue to make acquisitions of, or significant investments in, businesses that offer complementary products, services, and technologies" (Exhibit R-7 at p. 25).

SUBSIDIARY 1

16. SUBSIDIARY 1 ("SUBSIDIARY 1") was organized in 1986 to market PETITIONER's products and services in COUNTRY 1.

17. PETITIONER REP 2 testified that PETITIONER owned 100% of SUBSIDIARY 1 until approximately 1990, when PETITIONER first sold a portion of its holdings in the company. By 1999, PETITIONER had reduced its ownership interest in SUBSIDIARY 1 to approximately 90%.

18. In 1999, SUBSIDIARY 1 became the first of PETITIONER's subsidiaries to be subject to a public offering. After the public offering, PETITIONER's ownership in SUBSIDIARY 1 was reduced to approximately 85% (Exhibit R-7 at p. 48).

19. The SUBSIDIARY 1 stock gains at issue in this appeal arose in April 2000, when PETITIONER sold additional shares of SUBSIDIARY 1. These sales resulted in PETITIONER's ownership interest being reduced to approximately 74% (Exhibit R-7 at p. 48).

20. PETITIONER REP 2 testified that PETITIONER was not regularly in the business of selling stock. He explained that PETITIONER sold 10% of its interest in SUBSIDIARY 1 in 2000 because the stock price had escalated to a level where the price earnings ratio was extremely high. PETITIONER REP 2 further stated that the market forces that caused SUBSIDIARY 1's stock to increase in value had no relationship to PETITIONER's Utah activities.

21. PETITIONER REP 2 also testified that officers and directors of SUBSIDIARY 1 received stock options in SUBSIDIARY 1. In contrast, he stated that employees in PETITIONER's other worldwide subsidiaries received stock options in PETITIONER.

22. Should the Commission determine the SUBSIDIARY 1 gains to be business income subject to Utah taxation, PETITIONER REP 2 proposed an alternative apportionment methodology to tax this income. PETITIONER REP 2 stated that the alternative methodology is necessary in order for Utah's taxation to be "equitable." He testified that other tribunals, such as one in STATE 1, had accepted the alternative methodology. He admitted that Idaho has initially rejected the proposed alternative methodology, but stated that the matter was still in litigation.

23. For purposes of the SUBSIDIARY 1 income only, the alternative apportionment methodology that PETITIONER REP 2 proposed would eliminate the property and payroll factors and add the income earned from the SUBSIDIARY 1 stock sales to the sales factor (Exhibit P-3). These adjustments would result in an apportionment factor of 0.0778%, which is much lower than Utah's 2000 UDITPA apportionment factor of 0.3657%. Application of the proposed alternative apportionment factor would reduce the amount of Utah tax due on the SUBSIDIARY 1 gains from $$$$$ to $$$$$.

SUBSIDIARY 2

24. Prior to 1997, PETITIONER owned a subsidiary called SUBSIDIARY 11 ("SUBSIDIARY 11"). PETITIONER REP 2 testified that SUBSIDIARY 11 was involved in the production of hardware not associated with PETITIONER's lines of business. PETITIONER REP 2 further explained that PETITIONER had "oversight" of SUBSIDIARY 11, even though the subsidiary had its own officers to manage it. SUBSIDIARY 11's legal, accounting, and tax matters were handled by PETITIONER for a fee.

25. PETITIONER REP 2 testified that by 1997, it did not appear that SUBSIDIARY 11's products were going to be successful. For this reason, PETITIONER purchased an entity called SUBSIDIARY 12 from COMPANY A because SUBSIDIARY 12's hardware products showed more promise. SUBSIDIARY 12 and SUBSIDIARY 11 were merged in 1997 and became SUBSIDIARY 2.

26. SUBSIDIARY 2's employees were the same ones who had previously worked for SUBSIDIARY 11. After the merger, PETITIONER owned approximately 70% of SUBSIDIARY 2, with COMPANY A owning a minority interest. A sale of stock in April 1999 reduced PETITIONER's ownership interest to approximately 59% (Exhibit R-7 at p. 48).

27. From 1997 through July 1999, PETITIONER and SUBSIDIARY 2 shared two directors. PETITIONER REP 2 testified that during this period, PETITIONER provided guidance at the

director level, but not at the management level. PETITIONER REP 2 also testified that SUBSIDIARY 2 had its own tax office after the merger.

28. In July 1999, SUBSIDIARY 2 was subject to a public offering. After the public offering, PETITIONER's ownership interest in SUBSIDIARY 2 was reduced from approximately 59% to approximately 48% (Exhibit R-7 at p. 48). In February 2000, PETITIONER REP 2 testified that PETITIONER sold additional SUBSIDIARY 2 stock, which reduced its ownership interest to approximately 30%. After the public offering, PETITIONER and SUBSIDIARY 2 no longer shared any directors.

29. At the time of the SUBSIDIARY 2 stock sales at issue, PETITIONER REP 2 testified that SUBSIDIARY 2 was in the business of selling "hardware-based items with a software component," specifically items to enable a customer to access Internet sites on televisions. PETITIONER REP 2 further stated that these items and SUBSIDIARY 2's activities were not related to PETITIONER's business activities.

30. Prior to and through fiscal year 2001, SUBSIDIARY 2 continued to license to PETITIONER a non-exclusive right to distribute SUBSIDIARY 2 products (Exhibit P-4 at p.1). PETITIONER REP 2 also testified that if a customer had a problem with SUBSIDIARY 2 products, an PETITIONER employee would investigate the problem, and PETITIONER would charge SUBSIDIARY 2 an arm's-length fee for the service. PETITIONER REP 2 testified that the amounts of these sales and services that PETITIONER performed were not significant.

31. In January 2001, PETITIONER created an irrevocable trust ("TRUST") to hold all of its shares in SUBSIDIARY 2. The TRUST provides that PETITIONER controls the timing of its sales of SUBSIDIARY 2 shares, subject to a standstill agreement that places certain limitations on the volume of shares sold and the manner of sale (Exhibit R-7 at. p. 49).

32. Prior to 1997, SUBSIDIARY 11 rented office space from PETITIONER at market rates. Following the SUBSIDIARY 12 acquisition, SUBSIDIARY 2 continued to operate in these offices until

it built and moved into a new facility. Although PETITIONER initially guaranteed the loan for the new facility, PETITIONER REP 2 testified that PETITIONER ceased guaranteeing the loan in 1999 when SUBSIDIARY 2 was subject to its public offering.

33. SUBSIDIARY 11 also rented office space from PETITIONER in CITY 1, Utah and CITY 2, COUNTRY 2 at market rates. SUBSIDIARY 2 continued to rent these facilities until the leases expired in February 2000 for the Utah space and in October 2000 for the CITY 2 space. (Exhibit P-4 at p. 2).

34. In August 1997, PETITIONER and SUBSIDIARY 2 entered into a "tax sharing agreement" that appears to have been in effect during the 2000 tax year. The tax sharing agreement required the reimbursement of any tax benefits that PETITIONER received from including SUBSIDIARY 2 in an PETITIONER combined or consolidated return. However, no payments related to the agreement were made during the 1999 or 2000 fiscal years. (Exhibit P-4 at p. 1).

35. PETITIONER REP 2 testified that PETITIONER considered SUBSIDIARY 2 to be part of its unitary business for purposes of completing its 1997, 1998 and 1999 Utah returns. He added, however, that PETITIONER had considered SUBSIDIARY 2 part of its unitary business for these years because its ownership interest was greater than 50%. He stated that if PETITIONER were to make the determination today, it would conclude that SUBSIDIARY 2 was not part of PETITIONER's unitary business not only for the 2000 tax year, but also for the 1997, 1998 and 1999 tax years.

36. PETITIONER REP 2 admitted that STATE 2 audited PETITIONER's 2000 STATE 2 return, on which PETITIONER reported SUBSIDIARY 2 as part of its unitary business and characterized the SUBSIDIARY 2 income as business income. He stated that STATE 2 did not change these classifications.

SUBSIDIARY 5

37. PETITIONER REP 2 testified that PETITIONER made a series of purchases of SUBSIDIARY 5 stock in 1996 and held it for several years before selling it in the 2000 tax year.

38. The Division stated that SUBSIDIARY 5 was a computer company, a characterization that PETITIONER did not refute.

39. PETITIONER REP 2 characterized PETITIONER's ownership of the SUBSIDIARY 5 stock as a long-term investment. He further testified that PETITIONER and SUBSIDIARY 5 did not share any central management, any functional operations, or any economies of scale, which the Division did not refute.

SUBSIDIARY 4

40. PETITIONER REP 2 testified that PETITIONER purchased the SUBSIDIARY 4 stock at least one year prior to selling it in the 2000 tax year.

41. The Division stated that SUBSIDIARY 4 was a computer company, a characterization that PETITIONER did not refute.

42. PETITIONER REP 2 characterized PETITIONER's ownership of the SUBSIDIARY 4 stock as a long-term investment. PETITIONER REP 2 further testified that PETITIONER and SUBSIDIARY 4 did not share any central management, any functional operations, or any economies of scale, which the Division did not refute.

SUBSIDIARY 7

43. SUBSIDIARY 7 was a company that PETITIONER bought in fiscal year 1997 or 1998, at which time it became a division of PETITIONER. PETITIONER REP 2 explained that PETITIONER sold SUBSIDIARY 7's assets and discontinued the business in 2000 because the person who recommended the purchase lost influence at PETITIONER and because PETITIONER was no longer pursuing industry-specific products.

44. PETITIONER REP 2 explained that SUBSIDIARY 7 was in the business of providing industry-specific software for the extraction industry. He stated that SUBSIDIARY 7's and PETITIONER's products were not capable of being integrated.

45. PETITIONER REP 2 stated that he only knows of one other business, other than SUBSIDIARY 7, that PETITIONER had owned and sold.

46. The Division apportioned and taxed approximately $$$$$ in gains from SUBSIDIARY 7 for the 2000 tax year. PETITIONER REP 2 claims that the SUBSIDIARY 7 stock was worthless at the time SUBSIDIARY 7 was sold and that PETITIONER will soon be revising its federal tax returns to reflect this circumstance. However, PETITIONER REP 2 admitted that PETITIONER had not yet taken any action to amend its 2000 federal returns.

Royalty Income

47. PETITIONER REP 2 testified that PETITIONER received the royalty income at issue from its foreign subsidiaries.

48. PETITIONER REP 2 stated that these foreign subsidiaries were not included on the 2000 Utah return that PETITIONER filed on a water's-edge basis. As a result, the foreign subsidiaries' sales, payroll and property factors were not included in the Utah UDITPA factors.

49. PETITIONER proposes that the factors for its foreign subsidiaries be included in the Utah factors to apportion and tax its royalty income. Such an adjustment would reduce the amount of Utah taxes due on the royalty income. PETITIONER has not calculated what the reduction in Utah tax would be if the Commission were to accept its proposed apportionment changes.

APPLICABLE LAW

1. For purposes of the Utah Corporate Franchise and Income Taxes Act, Utah Code Ann. §59-7-101(28) (2000)[1] defines "unitary group," as follows:

> (a) "Unitary group" means a group of corporations that:
> (i) are related through common ownership; and
> (ii) are economically interdependent with one another as demonstrated by the following factors:
> (A) centralized management;
> (B) functional integration;
> (C) economies of scale.

2. Utah's Uniform Division of Income For Tax Purposes Act ("UDITPA") provisions are set forth in Title 59, Chapter 7, Part 3 of the Utah Code. UCA §59-7-303(1) provides that "[a]ny taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its adjusted income as provided in this part."

3. For purposes of the UDITPA provisions, UCA §59-7-302 defines "business income" and "nonbusiness income," as follows:

> (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.
> . . . .
> (4) "Nonbusiness income" means all income other than business income.

4. UCA §59-7-311 concerns "business income" and provides that "[a]ll business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

1 The 2000 version of Utah law is cited in this decision.

5. UCA §59-7-320 provides for the equitable adjustment of the standard allocation or apportionment method, as follows:

> If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) the exclusion of any one or more of the factors;
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

6. Utah Administrative Rule R865-6F-8 provides guidance concerning the classification of "business income" and the calculation of the three UDITPA factors, as follows in relevant part:

> A. Business and Nonbusiness Income Defined. Section 59-7-302 defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business operations. In essence, all income that arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of the Uniform Division of Income for Tax Purposes Act (UDITPA), the income of the taxpayer is business income unless clearly classifiable as nonbusiness income.
> 1. Nonbusiness income means all income other than business income and shall be narrowly construed.
> 2. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, and nonoperating income, is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is business income or nonbusiness income is the identification of the transactions and activity that are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer that are dependent upon or contribute to the operation of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of business, and will constitute integral parts of a trade or business.
> 3. Business and Nonbusiness Income. Application of Definitions. The following are rules for determining whether particular income is business or nonbusiness income:

a) Rents from real and tangible personal property. Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is in incidental thereto and therefore is includable in the property factor under G.1.a).

b) Gains or Losses from Sales of Assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income the gain or loss will constitute nonbusiness income. See G.1.b).

. . . .

J. Special Rules:

1. Section 59-7-320 provides that if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

a) separate accounting;

b) the exclusion of any one or more of the factors;

c) the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in this state; or

d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

. . . .

3. Sales Factors.

The following special rules are established in respect to the sales factor of the apportionment formula:

a) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

b) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, and business automobiles.

. . . .

DISCUSSION

Utah has adopted the UDITPA provisions to determine the portion of income from a multi-state business that is subject to Utah tax. These provisions are contained at Utah Code Ann. §59-7-302

through §59-3-321 and provide the formula for allocating and apportioning multi-state income. The formula divides income into two separate categories, i.e., business income and nonbusiness income. Business income is apportioned to each state through the use of a three-factor formula that is based on the taxpayer's property, sales and payroll in a particular state in comparison to its total property, sales and payroll. Nonbusiness income is generally allocated to the state in which the taxpayer is domiciled.

I. Are the Gains the PETITIONER Received from the Sale of SUBSIDIARY 1 Stock and Sale of SUBSIDIARY 7 Assets Considered "Business Income" that is Subject to Utah Taxation?

PETITIONER conceded that SUBSIDIARY 1 and SUBSIDIARY 7 are part of PETITIONER's unitary business. PETITIONER contends, however, that Utah may not apportion and tax the gains from SUBSIDIARY 1 and SUBSIDIARY 7 because these gains are not "business income," as defined in Utah law. Section 59-7-302 defines "business income," as follows:

> (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.

The Commission notes that there is a strong inference that income is "business income." Rule R865-6F-8(A) ("Rule 8") provides that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Furthermore, Rule 8(A)(1) specifies that "nonbusiness income . . . shall be narrowly construed."[2]

In addition, the Commission has consistently found that Utah's definition of "business income" includes two separate tests that are commonly referred to as the "transactional" test and the

2 The rule is supported by United States Supreme Court rulings, which clarify that the taxpayer has the "distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed." *See Container Corp. v Franchise Tax Bd,*, 463 U.S. 159 (1983); *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980).

"functional" test. The transactional test concerns income that arises "from transactions and activity in the regular course of the taxpayer's trade or business." The functional test concerns "income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations." The Commission has determined that the definition of "business income" requires that only one or the other of the two tests be met, an interpretation supported by cases in other jurisdictions with a similar definition.[3]

The Commission has recognized and applied the functional test in its prior decisions.[4] The Commission has consistently found that the functional test applies when the asset that generated that income "served a useful purpose in furthering one of the business lines of the taxpayer, or provided some synergism for one of the business lines of the taxpayer, or the subsidiary generated business income" (USTC Appeal No. 01-0172 at p. 4). Furthermore, Rule 8(A)(3)(b) recognizes the functional test, providing that "[g]ain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business."

The Commission's interpretation of "business income" and application of the functional test is consistent with the STATE 2 Supreme Court's holding in *Hoechst.* In that case, the STATE 2 court interpreted STATE 2's definition of "business income," which is the same as Utah's, and found as follows:

> Forming these interpretations of the statutory language into a cohesive whole, we conclude that income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations. Such an interpretation of the functional test flows from the ordinary meaning of the statutory language and the STATE 2 decisions that formed the basis

---

3 *See Polaroid v. Offerman*, 507 S.E.2d 284 (N.C. 1998); *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001).

4 USTC Appeal Nos. 90-1607, 90-1521, 93-0481, 97-1416, 93-0004, and 01-0005.

for the UDITPA definition of "business income."[5]

Based on these authorities and interpretation of "business income," the Commission will determine whether the gains from the sale of SUBSIDIARY 1 stock and SUBSIDIARY 7 assets qualify as business income under the functional test.[6]

SUBSIDIARY 1. PETITIONER does not contest that SUBSIDIARY 1 is part of its unitary business. SUBSIDIARY 1 has been part of the unitary business since it was created in 1986 as a subsidiary to market PETITIONER's products and services in COUNTRY 1. Furthermore, PETITIONER reported the SUBSIDIARY 1 gains as business income on its STATE 2 tax returns. SUBSIDIARY 1 clearly was used in the taxpayer's trade or business that it conducted in Utah. As a result, the Commission rejects PETITIONER's argument that SUBSIDIARY 1 was a "self-contained" entity with little or no relationship with any American state. Under the functional test that the Commission has consistently employed, the Commission finds that the sale of SUBSIDIARY 1 stock resulted in business income that is subject to Utah taxation.

SUBSIDIARY 7. PETITIONER also does not contest that SUBSIDIARY 7 was part of its unitary business. Although SUBSIDIARY 7 may not have been one of PETITIONER's "main" lines of business, PETITIONER operated the subsidiary as one of its divisions. As a result, the Commission does not consider SUBSIDIARY 7 to be a passive investment. Instead, SUBSIDIARY 7 contributed materially to the taxpayer's production of business income. Accordingly, under the functional test, the Commission finds that the sale of SUBSIDIARY 7's assets resulted in business income that is subject to Utah taxation.

---

5 The definition of "business income" contains the phrase "acquisition, management, and disposition." PETITIONER argues that the construction of this phrase requires that the "disposition" of assets be an integral part of PETITIONER's regular trade or business in order for the functional test to be applicable. In *Hoechst*, the STATE 2 court interpreted the "business income" definition as a "cohesive whole" and found otherwise. The Commission finds the STATE 2 court's reasoning and interpretation to be convincing.

6 At issue is whether the gains are business income under the functional test. Neither party claims that the gains qualify as business income under the transactional test.

II. Are the Gains that PETITIONER Received from SUBSIDIARY 2, SUBSIDIARY 4 and SUBSIDIARY 5 Considered Business Income that is Subject to Utah Apportionment and Taxation?

PETITIONER argues that the gains realized from the sale of SUBSIDIARY 2 stock and the assets of SUBSIDIARY 4 and SUBSIDIARY 5 are not apportionable business income because none of the three entities was a part of PETITIONER's unitary business. The Division argues that regardless of whether the entities were part of PETITIONER's unitary business, the gains are taxable business income because these assets served an operational rather than an investment function in PETITIONER's business.

The United States Supreme Court has clarified that income derived from a taxpayer's unitary business may be apportioned among the various states in which the taxpayer conducts its unitary business. *See Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980); *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation and Revenue Dept.*, 458 U.S. 354 (1982); *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Allied-Signal, Inc. v. Director, Div. of Taxes*, 504 U.S. 768 (1992).

In A*llied-Signal*, the Court also explained that "situations could occur in which [UDITPA] apportionment might be constitutional even though "the payee and that payor [were] not . . . engaged in the same unitary business." Specifically, the Court determined that an "asset" could form part of a taxpayer's unitary business if it served an "operational" rather than an "investment" function in that business. Although PETITIONER argued otherwise, the Commission finds that the Court recently reconfirmed its *Allied-Signal* position in *MeadWestvaco v. Illinois Dep't of Revenue*, 2008 U.S. LEXIS 3473 (2008). In *MeadWestvaco*, the Court found that "[t]he concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a 'unitary relationship' does not exist between the 'payor

and payee'". With this guidance, the Commission will determine whether Utah may apportion and tax the SUBSIDIARY 2, SUBSIDIARY 5 and SUBSIDIARY 4 gains.

SUBSIDIARY 2. In July 1999 (during the 2000 tax year), PETITIONER's ownership interest in SUBSIDIARY 2 decreased from approximately 59% to 48%. Additional sales of SUBSIDIARY 2 stock in February 2000 further reduced PETITIONER's ownership interest to approximately 30%. Because PETITIONER's ownership interest in SUBSIDIARY 2 dropped below 50% in July 1999, PETITIONER and SUBSIDIARY 2 no longer had a unitary relationship at this point. In 2001, PETITIONER placed its remaining SUBSIDIARY 2 shares in the TRUST. It appears that from 1999 through 2001, PETITIONER was taking steps to "shift" SUBSIDIARY 2 from serving an operational function in its business to an investment function. Nevertheless, the Commission believes that the SUBSIDIARY 2 assets continued to serve an operational function in PETITIONER's business at the time the 2000 gains at issue were realized.

A significant business relationship existed between SUBSIDIARY 2 and PETITIONER for years prior to and including 2000. PETITIONER guaranteed leases or loans associated with SUBSIDIARY 2's office space until July 1999, when SUBSIDIARY 2 was subject to a public offering. PETITIONER also had a non-exclusive right to sell SUBSIDIARY 2's products through, at least, 2001. Furthermore, PETITIONER investigated problems that a SUBSIDIARY 2 client was experiencing with SUBSIDIARY 2 products. PETITIONER also claimed SUBSIDIARY 2 as part of its unitary group for tax purposes for years prior to 2000 and benefited from reporting losses incurred by SUBSIDIARY 2 on its combined returns. Based on the foregoing, the Commission believes that PETITIONER's ownership of SUBSIDIARY 2 went well beyond a passive investment in a business enterprise.

As a result, the Commission finds that PETITIONER has failed to meet its burden of establishing that inclusion of the SUBSIDIARY 2 gains in PETITIONER's apportionable business income is inconsistent with the constitutional constraints set forth by the United State Supreme Court. Furthermore,

under the functional test discussed earlier in this decision, the Commission finds that the gains realized from the sale of SUBSIDIARY 2 stock qualify as business income. Accordingly, the Commission finds that the SUBSIDIARY 2 stock gains at issue result in business income subject to Utah apportionment and taxation.

SUBSIDIARY 5 and SUBSIDIARY 4. There is no evidence to refute PETITIONER REP 2's testimony that SUBSIDIARY 5 and SUBSIDIARY 4 were operated as discrete business enterprises that were separate from PETITIONER. The relationship between PETITIONER and these two entities appears indistinguishable from the circumstances present in *ASARCO* and *Woolworth*, cases in which the United States Supreme Court found that a unitary relationship did not exist. Furthermore, the Commission is not convinced that the assets of SUBSIDIARY 5 or SUBSIDIARY 4 served an operational function in PETITIONER's business. For these reasons, the Commission finds that neither SUBSIDIARY 4 nor SUBSIDIARY 5 was unitary with PETITIONER. Accordingly, the Commission finds that the income realized from selling the assets of SUBSIDIARY 5 and SUBSIDIARY 4 is nonbusiness income that is not subject to Utah apportionment and taxation.

III. Has PETITIONER Demonstrated that the Standard UDITPA Formula Should be Adjusted for Purposes of Apportioning its Royalty Income from Foreign Subsidiaries?

PETITIONER received approximately $$$$$ in royalty income from its foreign subsidiaries for the 2000 tax year. PETITIONER admits that its royalty income is business income and that it is subject to Utah apportionment and taxation. Under UDITPA, PETITIONER's business income is apportioned based on factors derived from PETITIONER's total payroll, property and sales. Because PETITIONER filed its Utah return on a water's-edge basis, the factors used to apportion its income were based on its property, sales and payroll in the United States only. Had PETITIONER chosen to file its Utah return on a worldwide basis, as it did in STATE 2, the factors would have been based on its property, sales and payroll in other countries, as well.

For purposes of apportioning its royalty income, PETITIONER contends that Utah's factors should be adjusted to reflect the property, sales and property of the foreign subsidiaries that paid royalties to PETITIONER. The Division, on the other hand, argues that an adjustment is inappropriate because PETITIONER could have filed its Utah return on a worldwide basis, but chose to file on a water's-edge basis.

PETITIONER contends that similar circumstances have resulted in other states finding that an adjustment to UDITPA was appropriate, specifically in *American Telephone & Telegraph Co. v. Dep't of Revenue, 422 N.W.2d 629, 1988 Wisc. App. LEXIS 62 (*Wis. Ct. App. 1988); *In the Matter of British Land (Maryland), Inc. v. Tax Appeals Tribunal of the State of New York, et al.*, 647 N.E.2d 1280, 1995 N.Y. LEXIS 137 (N.Y. 1995); *GATX Corporation v. Limbach, Tax Commr.*, 486 N.E.2d 840, 1984 Ohio App. LEXIS 12647 (Ohio Ct. App. 1984); *Microsoft Corporation v. Franchise Tax Board*, 139 P.3d 1169, 2006 Cal. LEXIS 9522 (Cal. 2006).

The Commission does not believe that the circumstances in these cases are similar to the circumstances involving PETITIONER's royalty income.[7] In this matter, the income at issue concerns

---

7 *American Telephone & Telegraph* involved intangible income that AT&T received from its subsidiaries, a portion of which involved royalty income. However, in this case, the $$$$$ of income associated with AT&T's subsidiaries exceeded AT&T's other income by approximately 500%. In PETITIONER's case, its royalty income is less than 10% of its total income.

British Land (Maryland) concerned a company that owned two properties, one in Maryland and one in New York. The sale of the Maryland property resulted in New York taxing 64% of the income realized from the Maryland gain, even though the gains were earned primarily prior to the taxpayer entering the New York market. Such circumstances are not present in PETITIONER's case.

In *GATX*, an Ohio court found that the payroll factor should be removed from the apportionment formula where the payroll factor was 13 times greater than the property factor and 27 times greater than the sales factor. In PETITIONER's case, the three factors for 2000 are 0.2439% for the property factor, 0.3872% for the payroll factor, and 0.4659% for the sales factor (Exhibit P-3). None of the Utah factors is even twice as great as another factor.

The *Microsoft* case concerned short-term investments, specifically the company's redemption of marketable securities at maturity. A STATE 2 court found that "mixing the gross receipts from the company's short-term investments with the gross receipts from its other business activity seriously distorted the standard formula's attribution of income to each state." None of the income in PETITIONER's appeal involved short-term investments.

royalties that PETITIONER received from foreign subsidiaries. Furthermore, under the standard UDITPA formula, less than one percent of PETITIONER's total income, including its royalty income, is being apportioned to Utah.

PETITIONER also notes that UCA §59-7-106(11)(b) establishes that the standard UDITPA factors are to be adjusted when determining the amount of a foreign subsidiary's dividends that are apportionable to Utah.[8] PETITIONER argues that for purposes of equity, the Commission should also make factor adjustments in regards to royalties paid by foreign subsidiaries. The Commission disagrees. The Legislature specifically enacted Section 59-7-106(11)(b) to apply to dividends and could have included an adjustment for royalty income. It did not do so.

Lastly, the Commission notes that adjustments to the UDITPA methodology are rare. William J. Pierce, one of the original proponents of UDITPA, wrote that "departures from the basic formula should be avoided except where reasonableness requires."[9] Mr. Pierce further indicated that "a reading of the Supreme

---

8 Section 59-7-106 provides, as follows:

> In computing adjusted income the following amounts shall be subtracted from unadjusted income:
> . . . .
> (11) (a) 50% of the dividends deemed received or received from subsidiaries which are members of the unitary group and are organized or incorporated outside of the United States unless such subsidiaries are included in a combined report under Section 59-7-402 or 59-7-403. . . .
> (b) in determining income apportionable to this state, a portion of the factors of a foreign subsidiary whose dividends are partially excluded under Subsection (11)(a) shall be included in the combined report factors. The portion to be included shall be determined by multiplying each factor of the foreign subsidiary by a fraction, but not to exceed 100%, the numerator of which is the amount of the dividend paid by the foreign subsidiary which is included in adjusted income, and the denominator of which is the current year earnings and profits of the foreign subsidiary as determined under the Internal Revenue Code;
> . . . .

9 Pierce, *The Uniform Division of Income for State Tax Purposes*, TAXES The Tax Magazine, October 1957 at p. 781.

Court decisions indicates that it is extremely difficult for any taxpayer to show that the use of a formula causes an arbitrary and unreasonable levy in relation to local business activity."[10] Furthermore, PETITIONER's argument that Utah's UDITPA methodology should be adjusted is invalid unless it proves "by 'clear and cogent evidence' that the income attributed to the State is, in fact, 'out of all appropriate proportions to the business transacted . . . in that State' . . . or has 'led to a grossly distorted result.'" *Container Corp. v. Franchise Tax Bd*., 463 U.S. 159 (1983) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978)). Furthermore, in *Western Contracting Corp. v. State Tax Commission*, 18 Utah 2d 23, 414 P.2d 579 (Utah 1966), the Utah Supreme Court found that for a unitary business, the proportion of net income to be allocated to Utah must be determined by the UDITPA formula "unless the party opposing the application of such formula shall prove by clear and convincing evidence that the taxes so imposed are grossly disproportionate to the business conducted in this state. . . ."

The Commission finds that PETITIONER has not met the high standards required to show that an adjustment to Utah's UDITPA formula is necessary for the royalties it received from its foreign subsidiaries. Such an adjustment would reduce the apportionment factor, and there is no reason why more of PETITIONER's royalty income should be allocated to another state than to Utah. In addition, PETITIONER affirmatively chose not to file its Utah return on a worldwide basis. Worldwide reporting would have resulted in a smaller apportionment factor, as PETITIONER proposes. Of course, filing on a worldwide basis could have also resulted in the apportionment factor being applied to a greater amount of total income, as the income received by the foreign subsidiaries would be apportioned as well. It is possible that PETITIONER's tax liability under worldwide reporting would have exceeded its liability under water's-edge reporting. For these reasons, the Commission finds that the standard UDITPA apportionment formula provides a reasonable

10 *Id*. at p. 748.

approximation of PETITIONER's royalty income in relation to its operations in Utah. Accordingly, the Commission finds that adjustments to the standard UDITPA formula are unnecessary in regards to the royalty income that PETITIONER received from its foreign subsidiaries.

IV. Has PETITIONER Demonstrated that the Standard UDITPA Formula Should be Adjusted for Purposes of Apportioning the SUBSIDIARY 1 Income?

The Commission has found that the gains PETITIONER received from its sale of SUBSIDIARY 1 stock is apportionable business income. In case the Commission reached this conclusion, PETITIONER argues that application of the standard three-factor UDITPA formula would result in unconstitutional inequities. PETITIONER argues that use of the UDITPA formula does not apportion the SUBSIDIARY 1 income in a manner that fairly reflects PETITIONER's activities in Utah. PETITIONER proposes that for purposes of apportioning the SUBSIDIARY 1 income, the formula should be adjusted to eliminate the property and payroll factors and to add the income received from the SUBSIDIARY 1 stock to the sales factor. The Division contends that the alternative apportionment should be denied because the standard formula apportions the SUBSIDIARY 1 income in a manner that is sufficiently reasonable to satisfy constitutional review.

PETITIONER contends that the four cases cited in the prior section concerning royalty income also show that the standard formula should be adjusted for its SUBSIDIARY 1 income. Again, the Commission does not believe that the circumstances in those cases are present in this matter. Moreover, for the same reasons discussed above concerning the royalty income, the Commission does not find that an adjustment to the apportionment formula is required. As quoted above, the court in *Container* found that an adjustment is unwarranted unless the taxpayer meets the high burden of showing that the taxes imposed by the formula are grossly disproportionate to the business conducted in this state. PETITIONER could have filed its Utah return on a worldwide basis, which would have considered the factors of foreign subsidiaries. PETITIONER did not

do so. The Commission once again sees no reason why more of the SUBSIDIARY 1 gains should be allocated to another state than to Utah. There is no evidence to suggest that SUBSIDIARY 1 contributed more to PETITIONER's operations in another state than in Utah. Accordingly, the Commission is not convinced that the apportionment of less than one percent of the SUBSIDIARY 1 income to Utah is grossly disproportionate.

PETITIONER also argues that its proposed adjustment to the sales factor is anticipated by Rule 865-6F-8(J)(3). This rule applies to circumstances where gross receipts should be **excluded** from the sales factor. PETITIONER is asking for the SUBSIDIARY 1 income to be **included** in the sales factor. The Commission believes that PETITIONER's request would result in an inequitable amount of income being apportioned to Utah in comparison to other states and finds that the rule is not controlling under the circumstances.

Based on the foregoing, the Commission finds that PETITIONER has not met the high standards required to show that an adjustment to Utah's UDITPA formula is necessary for its SUBSIDIARY 1 income. The Commission finds that the standard UDITPA apportionment formula provides a reasonable approximation of the SUBSIDIARY 1 income in relation to its operations in Utah. PETITIONER's proposed adjustments are denied.

CONCLUSIONS OF LAW

1. Under the functional test that the Commission has consistently employed, the Commission finds that the sale of SUBSIDIARY 1 stock and sale of SUBSIDIARY 7 assets resulted in business income that is subject to Utah apportionment and taxation.

2. The Commission finds that SUBSIDIARY 2 served an operation function instead of an investment function in PETITIONER's business. For this reason and in accordance with the functional test, the Commission finds that the sale of SUBSIDIARY 2 stock resulted in business income that is subject to Utah apportionment and taxation.

3. The Commission finds that SUBSIDIARY 5 and SUBSIDIARY 4 were not unitary with PETITIONER and that they served an investment, and not an operational, function in PETITIONER's business. For these reasons, the Commission finds that the SUBSIDIARY 5 and SUBSIDIARY 4 gains are not business income subject to Utah apportionment and taxation. Accordingly, the Division's assessment of tax on these gains is reversed.

4. The Commission finds that PETITIONER has not shown that an adjustment to Utah's UDITPA formula is necessary for purposes of apportioning the royalty income that PETITIONER received from its foreign subsidiaries.

5. The Commission finds that PETITIONER has not shown that an adjustment to Utah's UDITPA formula is necessary for purposes of apportioning the income that PETITIONER received from its SUBSIDIARY 1 stock sales.

DECISION AND ORDER

Based upon the foregoing, the Commission abates the taxes imposed on the income that PETITIONER received from its sale of SUBSIDIARY 5 and SUBSIDIARY 4 assets. Otherwise, the Division's assessment is sustained. It is so ordered.

DATED this _____ day of _____, 2008.

_____
Kerry R. Chapman
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2008.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

NOTICE OF APPEAL RIGHTS: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601 and 63-46b-13 et. seq. Failure to pay any remaining balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

KRC/04-0970.fof